THE DELICATE QUESTION OF RAILWAY CREDIT

BY FRANKLIN ESCHER

In no clearer way can the present state of railway credit be set forth than by the bare statement that the railways have practically stopped offering new issues of bonds to the investment-buying public. With traffic moving in the greatest volume ever known and railway facilities very much curtailed as a result of two years of enforced economy, there is every reason why the railroads should be in the market for funds. But such is not the case. Like the man who knows that his credit isn't good and so very wisely keeps away from the bank, railway finance managers are very wisely forbearing to ask investors to subscribe to new issues of railway securities. When those roads whose need for capital is so urgent that they cannot wait are seen paying eight and ten per cent. for the money they cannot do without, most borrowers prefer to keep out of the market altogether.

For the present unwillingness on the part of investors to buy railway bonds—or, putting it another way, to lend money to the railroads—uncertainty as to the effect on earnings of the attitude assumed by the Interstate Commerce Commission during the past couple of years has been directly responsible. During the quarter-century of its existence the Commission has at all times exerted more or less of an influence on railway affairs, but it is only since the summer of 1910, when by Act of Congress its authority was greatly increased, that the Commission's regulatory power has been really strongly exercised. Early in that year, following the threat of a general strike, the railroads granted extensive wage increases to their employees, appealing to the Commerce Commission at the same time for permission to raise their freight-rates correspondingly. That general appeal

was flatly denied, as has been practically every other individual one since made. To the railway mens' repeated statements that a point has been reached where, unless the transportation industry is seriously to suffer, freight-rates have got to be raised, the Commerce Commissioners by word and action have steadily made reply that rates are high enough as they are. On the whole plea of the railroads, indeed, that the increase in their operating expenses brought about by the higher cost of materials and labor entitles them to charge more for the transportation they have to sell, the attitude of the Commission has been absolutely uncompromising.

With one big railroad man after another coming out openly with statements that unless there is a change in the Commerce Commission's attitude a number of important properties will before long find themselves threatened with insolvency, it is hardly to be wondered at that investors are chary about putting their money into railroad securities. It is realized, of course, that the railway men who have been making these very strong statements are, so to speak, interested parties. But, on the other hand, there seems to prevail a strong conviction that unless the railways' need for more revenue were really urgent, these leading figures in the transportation world would hesitate about making statements so certain to bring about further impairment in the investment standing of their own securities. For them to urge the need of higher freight-rates is all very well; it is they themselves who have everything to gain. But unless there were justice in their claims—unless, indeed, the prosperity of the industry does depend upon a change in the treatment accorded the railways, would these authorities go on telling the public the very things best calculated to make it draw its purse-strings even closer, and most certain to make the path of the railroad seeking new capital even thornier than it is now? By the very frankness with which such men as President Ripley, of the Atchison, President Brown, of the New York Central, and President Finley, of the Southern, have been stating their case, they have convinced a good many thinking people that this is no mere attempt on the part of the transportation interests to get more money out of the shippers, but an honest attempt to preserve the integrity of the industry in which they are engaged.

The proportion of the public, however, which has been reached by the fair and frank statements of Messrs. Ripley, Brown, Finley, and the others is almost inconsiderable in comparison with the very large number of persons who believe that the railroads are making plenty of money and that their rates, if anything, should be reduced and not advanced. There has been some subsidence, it is true, in the wave of anti-railroad sentiment which swept the country a couple of years ago and made itself felt in the passing by State legislatures of hundreds of ill-considered anti-railroad laws and regulations. But, although the number of such laws actually put on the statute-books has shown a great falling off during the past year, there is still running strong a current of anti-railroad feeling which is heard in frequent propositions that a physical valuation of the railways be made the basis of a new structure of freight-rates, that railway profits be limited by law, and that Government sanction be required for new issues of securities. Here and there outside of transportation circles a man can be found who believes that the railways are not being treated justly, but in the opinion of the vast majority of people they are getting no more than they deserve. Talk to the average man about the plight the railroads are in, and he will tell you that they are not in any plight, but making lots of money and well able to take care of themselves. The rates they charge for carrying freight, he will probably inform you, are high enough; it would be a good thing, indeed, from *his* point of view, if the Government were to step in and fix things so that the railroads could earn a fair return on the actual amount of money invested, and no more.

Just here we come to the root of the whole trouble—the rapid spread of the idea that the railway is nothing but a public servant, after all, and that as such it ought not to be allowed to earn anything more than a moderate return on the actual amount of its investment. Let us find out how much *is* actually invested in the railways, goes the demagogic cry, and then let us make the railways fix their freight-rates accordingly. To you, shippers of freight, it will mean a much lower charge for sending your product to market. To you, the general consumer, it will mean a corresponding reduction in prices.

Great is the popularity achieved by the idea. Everywhere people have been speaking of the advisability of a physical

valuation of railways and "the lowering of the cost of living" which would result from a readjustment of freight-rate schedules. That is perfectly plain and can be understood by anybody. It is much plainer and easier to understand, for instance, than further considerations having to do with reactive effects such a course of action may be expected to exert upon general business. By those advocating the thing that side of it has been carefully kept in the background—along with the question of any rights the railways or the holders of railway securities may have in the matter. Prices to the consumer are to be lowered. Is not that enough?

By the leaders of thought in the railway world the prevalence of this idea is fully appreciated, and it is realized just as fully that as long as it remains uncorrected in the public mind the uncompromising attitude of the Interstate Commerce Commission, which represents the public, is bound to remain unchanged. Only by getting the facts before the public, so that it may see how utterly unlikely such interference with freight-rates is to bring about lower prices, can public sentiment toward the railways be dissuaded from its pursuit of this *ignis fatuus* and brought back to solid ground.

Before anything in that line can be accomplished two great misconceptions must be corrected. The first is that freight-rates have anything to do with capitalization—that is to say, that what a railroad charges for carrying freight should in any way be influenced by the value of the railroad's property. The second is that anything can be gained for the shipper or the general public by limiting railway profits—that is to say, by passing laws that a railroad shall be allowed to earn only so-and-so much on the amount of money invested in the property.

It is the first of these two misconceptions which is probably the more wide-spread. Between capitalization and freight rates, in the average man's mind, there is a close connection. Time and again he has been told that most railways have a lot of watered stock outstanding on which dividends have got to be earned, and that in order to earn these dividends freight-rates have got to be higher than they would be if there were no watered stock to be taken care of. And that, of course, as anybody can see, is all wrong. Just because some railroad has issued a lot of

shares without anything tangible having been paid into the treasury in return, why should shippers along the line and the public in general be made to pay such freight-rates as to allow anything to be earned on this " water "? That as an argument sounds first class. It has, furthermore, been repeated so often that a very large number of people have come, almost unconsciously, to believe that it is true and to associate railway capitalization and railway freight-rates in their minds. A surprising proportion even of thinking people, indeed, believe that when the railways fix their freight-rates the chief consideration they have in mind is to get them high enough so that earnings can be shown on inflated capitalization.

Capitalization is not, never was, and never will be the basis of freight-rates, for the very simple reason that competing lines' capitalization almost invariably differs widely. Take the several roads which compete for business between New York and Chicago. Among them we find about the most conservatively capitalized railroad in the country, running almost side by side with the road that first comes into most people's minds when the subject of over-capitalization is brought up. This latter line we will say, for the purpose of the argument (or, rather, to show its absurdity), decides to fix its freight-rates on such a basis as will allow it to earn dividends on its ocean of common stock. What would be the inevitable result? Simply, of course, that the road wouldn't get any business, and that if it wanted to keep on earning anything at all it would quickly enough have to drop back its charges to a competitive basis—to what, from the shipper's standpoint, *its service is worth.*

What the service is worth—there we have the basis on which freight-rates are really fixed. Not what the railroad would *like* to get or what the capitalization makes it necessary to get in order to pay dividends, but simply what is the money equivalent of the service rendered. Selling railroad transportation is really no different from selling anything else. Imagine a merchant, about to fix a price on a lot of goods, saying to himself: " Here, I and my associates have capitalized this business at more than it is worth and now we have got to make enough money to keep up our dividend. I'll just put such a price on these goods as will allow us to make the amount of money we need." Would that be likely to accomplish the desired result? Hardly.

What does the consumer care about the amount of money the merchant considers it necessary to make? The goods, presumably, have a certain value and that value, or something approximating it, is all the purchaser is willing to pay. Let the merchant arbitrarily mark up the price and one of two things will surely happen—the purchaser will either go somewhere else or will refuse to buy entirely.

Just exactly that same thing is true of railway transportation. Where the question of competition comes in it is obviously impossible for a railroad, in fixing its rates, to pay any attention to what its existing capitalization may be. Nor, in the case where that railroad has a monopoly, is it going to be so foolish as to fix a rate which will impose any check upon the free movement of business. What the railroad wants to see is a constantly developing and enlarging volume of traffic and that result, it very well knows, can be accomplished only by the fixing of freight-rates which are a fair measure of the service rendered. The whole history of American railroading, indeed, is filled with instances of railroads built through territory in the development stage keeping their freight-rates *below* the value of the service rendered in order to give new industries located along the line a chance to get a foothold and grow strong. There is nothing altruistic about it. It is a matter of business pure and simple. The prosperity of the railroad depends upon the prosperity of the territory it serves, and for the railway to forego immediate returns in order to build up future business is a most reasonable sort of policy. The industries located along its lines having developed and become firmly established *as a result of low freight-rates,* the traffic can bear more and rates can be advanced to a point where the railway can make a reasonable profit out of handling the business.

Were the public cognizant of the fact that it is of such threads that the fabric of freight-rates is woven, the demand for a readjustment based upon a physical valuation of railway properties would die out overnight. The whole rate structure, it is plain, has been built up on the idea of developing traffic to the greatest possible degree—of letting a factory in the Middle West, for example, compete with a factory in New England for the New York market. Rates as we have them are not the result of chance or of any desire on the part of anybody to earn dividends on watered

stock. If there is anything sweetly reasonable about modern business it is just this system of railway freight-rates which has, perhaps, done more to develop the country's manufacturing interests than any other one thing. To attempt now to readjust this delicate mechanism on the idea that property investment should govern rates would be exactly like attempting to readjust the works of a chronometer with a crowbar.

The other thing which has done so much to hurt railway credit and keep investors from putting their money into securities of that sort is the spread of the idea that railway profits should be limited by law. A railway, the argument goes, is a public servant, doing its business by virtue of public favor and under a franchise granted by the people. Why, then, should the people allow the railway—any railway—to make large profits at their expense? A certain amount of capital has been invested, it is true, and on that it is only right that a fair return should be earned. But when profits go beyond what is a fair return, why, so the argument runs, should the public go on paying such rates for service as to make these profits possible? Why should not, then, rates be reduced to a point enabling the railroad to pay a fair dividend—say, six or seven per cent. at the outside—and no more?

Ignoring the right and wrong of such a proceeding—its hopeless injustice to those who have in good faith put their money into railway enterprise—and passing directly to the cold question of expediency, would the limitation of profits accomplish the end in view, the lowering of the actual cost of service? *Why, of course it would,* we hear it said; that's the point of the whole thing—to limit profits by making the railway charge less for its service. But just a moment. It stands to reason, of course, that if a railroad is making what is considered too much money and its rates are ordered reduced, its profits will be cut down. But suppose now that as a result of its profits having been cut down the railroad can't spend as much for improvements as it used to and there is deterioration in the service offered. Then how about the lower rates? Apparently they are lower, but are they really so? Well, the shipper pays less money. Yes, but not for the same thing. The railroad, perhaps, was contemplating buying a number of bigger engines or putting in double track or doing other things calculated to make it

possible to move freight faster and better. Very possibly now, with its margin of earnings so reduced, it will not feel like spending the money and the improvement in service will not be made. The shipper may be paying less, but he is getting correspondingly less for his money.

But is it a fact that if railway profits are limited by law deterioration of service is bound to follow? In the great majority of cases it is. A few of the big earners might be able to stand reduction of profits without its necessitating economies and so affecting the quality of their service, but the great majority of the railroads are in no position to stand reduction of any consequence in their net income accounts. A large proportion of railroad stocks pay no dividends at all, and in the case of those that do the margin of earnings above requirements is usually no more than enough to allow of necessary betterments and the adding of a little something to surplus account. The idea that American railroads as a whole earn any very great amount of money is very far from being the case. Take the rank and file of the dividend-payers, and it is undeniable that if anything were done further to limit the amount they are able to earn, expenses would have to be so curtailed as to effect serious impairment of service. And that, of course, would only come back on those "enjoying" the reduced freight-rates.

Then, again, were it ordained that a railroad could earn only so-and-so much, greater profits bringing about an automatic reduction in freight-rates, service would suffer because all incentive toward maximum efficiency would be destroyed. What would a road care? Its business having reached the point productive of the greatest revenue legally allowable, what incentive would there be toward better service and a greater degree of efficiency? Efforts in that direction in the conduct of any enterprise are the result of a desire to increase the volume of business and make more money, but in this case that desire would be lacking, or at least shut off by law. We are making all we are allowed to make, the railroad would say. Why should we go on trying to increase our business and improve our service when the only reward we can possibly expect is to have our freight-rates further reduced?

No, limiting railway profits by simply cutting down freight-rates is by no means as simple a proposition as it

would seem. The freight-rate structure, as we have seen, is no arbitrary creation of the railways, but has been piled up stone by stone over a long series of years, according to the needs and development of the country's business. With rates as they are the railroads as a whole are not earning enough money to enable them to make the improvements and extensions they ought to be making. Attempt to limit profits by reducing rates, and serious indeed will be the consequences.

For the present state of railway credit the prevalence of these two ideas is principally responsible. A large part of the public being firm in its belief that a physical valuation of the railroads ought to be made and the whole structure of freight-rates readjusted accordingly, and, furthermore, that no railroad ought to be allowed to earn more than a fixed amount, it is hardly to be wondered at that the investor refuses to put his money into new railway securities. There has been no general "valuation" of railway properties as yet, nor any legislation limiting the amount a railway can earn, but with the public feeling as it does, the danger of these things must be accounted great. Why, under such circumstances, should any one feel like putting money into new railway enterprise?

What is the remedy? How can confidence in railway securities be restored? In one way and in one way only: by putting before the public the facts in the case and relying upon that to bring about correction of the prevalent misapprehension concerning freight-rates. Let the public once see the true position the railways are in and there will be a speedy end to the talk about "valuation" and legal limitation of profits. Very quickly then will follow the restoration of railway securities to that high degree of investment favor they enjoyed but a very few years ago.

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